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Resolving Non-Performing Loans: Selected International Experience

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About the German Economic Team Belarus (GET Belarus)

The main purpose of GET Belarus is to conduct a dialogue on economic policy issues with the government, civil society, and international organizations. Experts of German Economic Team have experience in policy advice in several transition economies, including Ukraine, Russia, Georgia and Moldova. In Belarus, the German Economic Team provides information and analytical support to the Council of Ministers, the National Bank, the Ministry of Foreign Affairs, the Ministry of Economy and other institutions involved in the process of formation and implementation of economic policy.

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Resolving Non-Performing Loans: Selected International Experience

Executive Summary

Belarus is faced with a rapidly rising level of non-performing loans (NPLs) in its banking sector. This is not a unique feature; many countries in the world have experienced similar developments as NPL cycles are quite a regular feature of many financial systems around the globe. However, international experience also shows that high levels of NPLs pose a danger to financial and economic stability, and thus need to be comprehensively addressed by policymakers. A bank's high NPL stock depresses its earnings as it generates less interest income, requires loan-loss recognition and increases operating costs related to NPLs' management and work-out. Operating costs could be significant as the relevant skills are in short supply within the banking industry. Lack of profitability reduces the capital generated within banks, raises funding costs, and depresses credit growth. Credit will be constrained by all banks, impacting both healthy and distressed private sector borrowers.

As the authorities consider further structural reforms in the banking sector to break this negative feedback loop, this paper reviews the international experience in resolving NPLs, and the macroeconomic and financial dynamics that make NPL reductions so difficult to achieve. While each crisis is in a way unique, some general best practices can nevertheless be drawn:

- Strict regulation and supervision tailored to a systemic problem with loan defaults is important, but supervision should go beyond enforcing prudential standards and needs to address capacity gaps within the banks. Key areas where there could be convergence with EU practice is the adoption of a uniform asset classification methodology, the early and adequate provisioning against loans that are at risk, even they may not yet be in default (IFRS 9) as well as uniform standards in appraisals that provide consistent valuation of collateral.
- A key element in any NPL resolution strategy is the separation of distressed assets from the healthy part of a bank's balance sheet. While options exist for an asset separation that is limited to operational aspects, in the end only a complete separation of the affected assets into a legally distinct balance sheet will meet the dual objectives of restoring confidence and preventing a further drain on capital and profitability of the bank's core assets. Since an outright sale of NPLs to independent investors is generally difficult in emerging markets (including Belarus), the government may set up an asset management company (AMC). When distress from debt and NPLs is systemic, the government can consider a centralized AMC that will work with all distressed banks, as was done for instance in Spain (Sareb) or Ireland (Nama).
- NPL resolution efforts need to be matched by a strengthening of the legal regime for financial restructuring and insolvency. This is important so that banks and borrowers have a clear sense of the expected timeline and potential pay-offs in restructuring and potential liquidation. Also, where restructuring leads to an injection of fresh capital, and improved management, this may underpin a broader recovery in the corporate sector. It is crucial that this legal reform is accompanied by improved capacity in the courts, and among insolvency professionals. Crisis countries also facilitated out-of-court restructuring of over-indebted companies, including by defining guidelines for the coordination between multiple creditors.

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1. Introduction

At the end of 2016, the ratio of non-performing loans (NPLs) to assets subject to credit risk accelerated to 15 percent in Belarus, a level that is considered alarming in most countries. While the system-wide capital adequacy ratio (CAR) remains currently comfortably above regulatory norms (10.6%), a comprehensive asset-quality-review performed in mid-2016 revealed that in a stress-scenario the CAR would drop close to the regulatory norm.

As the authorities consider further structural reforms in the banking sector, it is an appropriate time to review the international experience in resolving NPLs, and the macroeconomic and financial dynamics that make NPL reductions so difficult to achieve. Experience stems from other emerging markets, but also from a range of other transition countries where a period of over-lending similarly led to wide-spread loan delinquency.

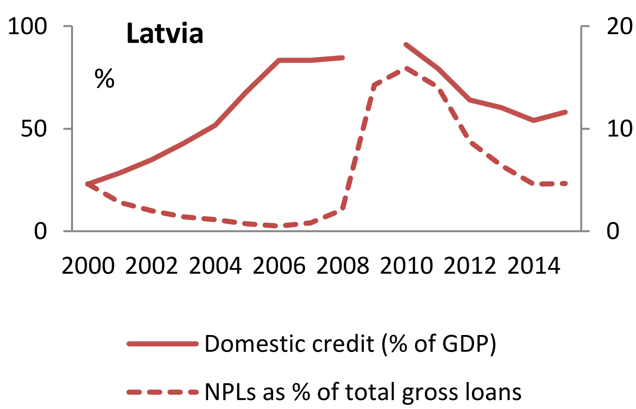
The paper is structured as follows: In chapter 2, we will demonstrate that high levels of NPLs are quite a regular feature of many financial systems around the globe. Thus, Belarus is not alone in that and can learn from the experiences of other countries. The underlying reasons why NPL pose a danger to financial and economic stability, and thus need to be addressed are explained in chapter 3. The following chapter 4 highlights some selected international experience with systemic NPL crises; some best practices in handling NPLs are described in chapter 5. How non-performing assets in banks can be separated from performing ones is the focus of chapter 6. A narrow focus on banks and their assets, however, won't solve the problem in its entirety; cases of unsustainable debt must be addressed through the restructuring and insolvency framework – this is discussed in chapter 7. We conclude in chapter 8 with some lessons for Belarus.

2. NPLs in the financial cycle

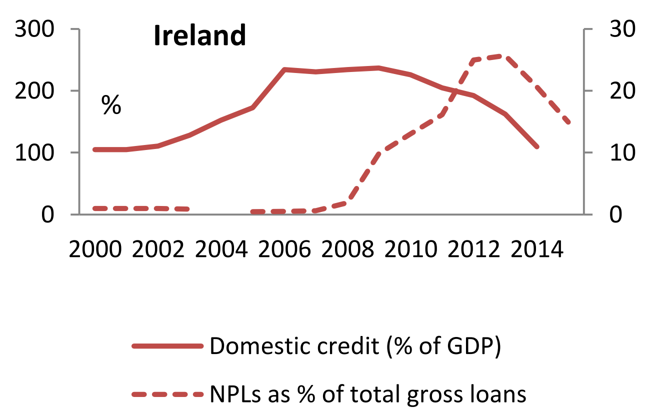
High levels of non-performing loans (NPLs) are a recurrent feature of all modern financial systems. Periodic retrenchment in lending, decline in borrower credit quality and increases in loan defaults are inherent in any financial system that is based on bank lending, and mirrors to some extent the normal economic cycle. In recent years, sizable NPL crises occurred in advanced countries, for instance with a peak in the NPL ratio at 25 per cent in Ireland, as well as in most emerging markets (Figure 1).

Figure 1

Domestic credit and non-performing loans: Latvia and Ireland



Source: World Bank; Note: no data available for domestic credit as % of GDP for 2009



Source: World Bank; Note: no data available for NPLs as % of total gross loans for 2004

As periodic increases in NPLs are unavoidable, the quality of a financial system is distinguished by the speed with which NPLs are recognized and resolved, and how quickly the banking system becomes functional again. In order for supervisors to detect incipient loan delinquency at an early stage a good working definition of loan performance is essential. This definition, and the resulting reports on asset quality by banks, inform prudential supervision, and as such may be quite specific to the context of the financial and legal system. A common basis is provided in the IMF's Financial Soundness Indicators[1], however, implementation has varied significantly, including on questions such as:

- What is the trigger for default (90 days is a generally accepted standard)?
- How are sovereign exposures and assets other than loans treated?
- How will forbearance be treated (the modification of the original loan terms)?
- Are NPLs classified only as those loans that have gone into default, or will all loans of a customer who has defaulted on a single loan count as such?
- Are NPLs reported gross or net of provisions, collateral, or the performing part of a loan?

Different national definitions have complicated the comparison of NPL data between countries.[2] Two recent standardization efforts could be relevant for Belarus. The EU in 2015 adopted a uniform definition, which then formed the basis for a series of asset quality assessments and stress tests.[3] This has given more confidence on bank asset quality to investors, and was a prerequisite for the common supervision through the ECB. Most recently, in April 2017 the Basel Committee on Bank Supervision (BCBS) adopted guidelines on the definition of non-performing assets to facilitate international comparisons.[4] International bodies such as the IMF or Basel Committee have few powers of enforcement, but rating agencies and investors are likely to push for greater consistency in NPL reporting.

While definitions may differ, the determinants of NPLs are very similar across countries. Economic growth has predictably been identified as the key factor.[5] Clearly, a prolonged recession will depress the earnings streams of enterprises, erode credit quality, make loan default more likely, and reduce recovery values. This dynamic will be reinforced by the tightening of lending standards by banks, which will lead to pro-cyclical constraints in refinancing opportunities.

Other factors such as movements in the exchange rate and interest rate may also play a role. This will be particularly relevant in emerging markets with underdeveloped local capital markets. Widespread currency substitution, or dollarization, in payments systems and lending is typically associated with unhedged open

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[1] See the IMF FSI website: https://www.imf.org/external/np/sta/fsi/eng/fsi.htm

[2] Bholat et al. (2016) and D'Hulster et al. (2014), see also the article at http://npl.vienna-initiative.com/wp-content /uploads/sites/2/2016/05/NPL-definitions.pdf

[3] Commission Implementing Regulation (EU) No. 680/2014, also reviewed in IMF (2015b)

[4] See https://www.bis.org/bcbs/publ/d403.htm

[5] Beck et al. (2013) find that for a panel of 75 advanced and emerging economies, real GDP growth is the most important determinant of asset quality.

currency positions on the balance sheets of enterprises and households. A depreciation of the local currency leads to an immediate decline in the borrower's net worth. Equally, the maturity of financial instruments is generally much shorter in such markets. An external shock to financing costs is more likely to translate into immediate stress in debt service costs for enterprises as well as households (e.g. mortgage loans).

In countries with poor standards in financial sector regulation and supervision the growth cycle is associated with the boom-bust pattern in the financial sector. Poor lending standards and inadequate monitoring of borrowers by the banks are thus the pre-cursor of an NPL crisis. There is also the risk that borrowers anticipate wide-spread debt-forgiveness and write-offs by banks, particularly where the insolvency framework is poorly developed or frequently revised. In this sense, loan defaults may become the result of moral hazard on the side of borrowers who default even though their underlying financial position is in essence sound. This is in particular true in emerging markets or transition countries where the rule of law is often rather weak.

3. Implications of high NPLs for the financial system and the real economy

Widespread loan defaults will have adverse effects throughout the financial system and real sector. It is important to bear in mind that these effects go well beyond the banks and their borrowers that are directly affected. Also, loan default is of course the mirror image of debt distress. Both emerge in parallel, and will need to be addressed simultaneously through a comprehensive strategy.

A bank's high NPL stock depresses its earnings as it generates less interest income, requires loan-loss recognition and increases operating costs related to NPLs' management and work-out. Operating costs could be significant as the relevant skills are in short supply within the banking industry. Lack of profitability reduces the capital generated within banks, raises funding costs, and depresses credit growth. This is a particular problem as younger and more productive firms will be starved of credit. As Figure 2 illustrates, it is essential to manage distressed bank assets, to break the negative feedback loop that will affect the entire financial and macroeconomic system.

Apart from the financial impact, there is a pervasive change in the internal management of the bank as human resources and managerial capacity are diverted away from operational units that generate new lending. Loan workout becomes increasingly central to the operations of the bank, and will further distract from the generation of new business.

These effects are well substantiated in numerous empirical studies. There is a clear correlation between individual banks' higher NPL ratios, and lower interest income, capital coverage and lending growth, higher funding costs and lower efficiency.[6]

It is clear that with these indicators of financial soundness compromised, credit will be constrained by all banks, impacting both healthy and distressed private sector borrowers.

A delinquent loan arises where a borrower is in excess debt. Failure to address NPLs perpetuates private debt that is not sustainable. In the empirical literature there is a consensus that above a certain threshold, debt has counterproductive effects. This is because beyond that point risks to solvency and liquidity are such that additional revenue from an improvement in demand is directed to debt service rather than investment and

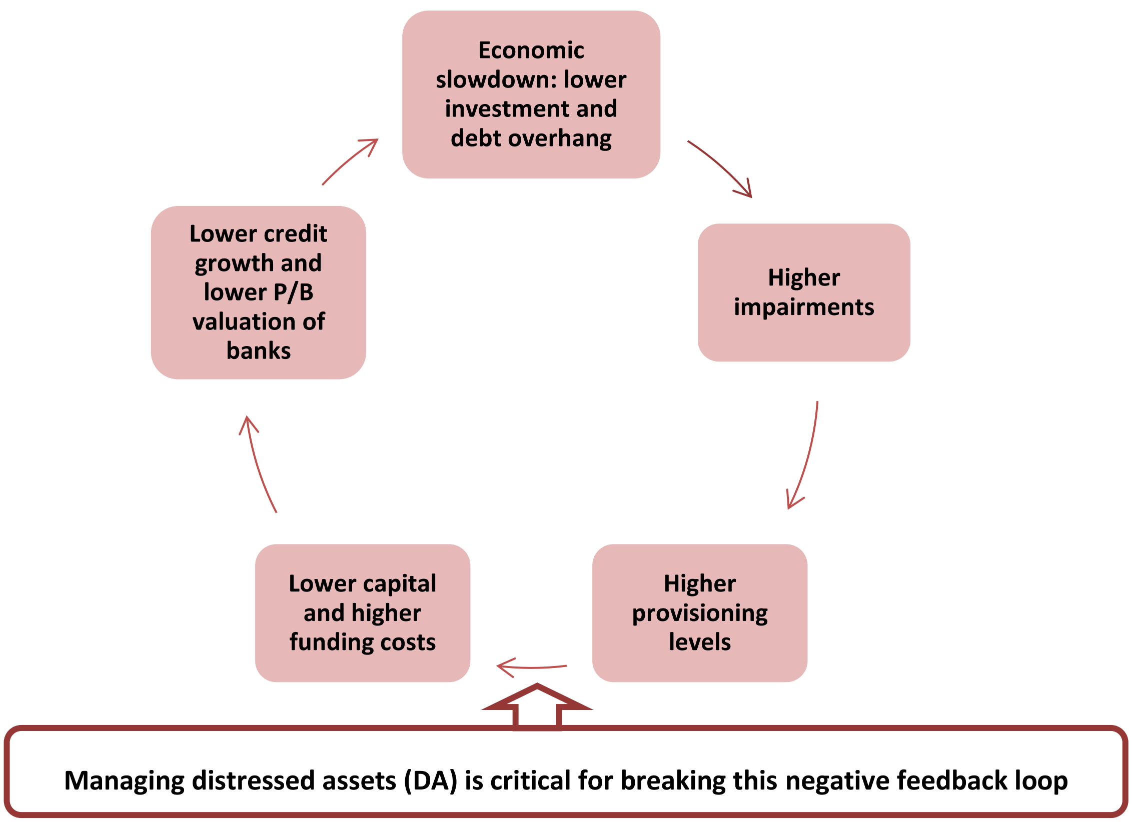
[6] IMF (2015a) and EBCI (2012). High NPL banks display higher interest margins which are a proxy for the operational costs banks take on in managing a more complex set of assets.

hiring. IMF (2015b) shows some striking results for the investment and hiring of a large sample of European firms. While those with low debt levels rapidly increased activity in response to an improvement in the external demand, those with very high debt levels showed a more muted response in terms of hiring, and even a more rapid deleveraging in response to such an improvement.

Where corporate debt distress becomes systemic debt-deflation dynamics could set in. In the context of weak demand prices of capital goods decline, employment falls, and as the general price level drops the real debt burden rises. A vicious circle takes hold between loan defaults, reduced lending by banks, and rising debt levels among households and enterprises. It is this experience of protracted high NPL levels and excess debt that has motivated many reforms to deal with the more recent crises in Europe.

Figure 2

Macro-financial impact of high non-performing loans



Source: World Bank.

4. The international experience with systemic NPL crises

Given successive waves of domestic financial liberalization and capital account opening the frequency of private debt crises and the associated spikes in banks' NPLs have become more frequent. There is hence a considerable stock of experience with successful NPL reductions on which a country such as Belarus can now draw (Figure 3).

- **Sweden's** success in the speedy resolution of its NPL crisis has been closely studied. Following a property market collapse, loan losses in 1992 alone amounted to 3.8 percent of GDP. But debt and

NPLs were primarily related to commercial real estate and mortgages, which helped in the design of focused asset management companies ('AMCs', also known as 'bad banks', see section 5 below). The government and central bank wanted a clean break for the healthy part of the banking system, and to let specialists focus on restructuring and value recovery. Professional management, political independence, and appropriate funding contributed to success. The recovery of the economy from 1994 and then in real estate markets was of course crucial in this regard.[7]

- By contrast, **Japan** delayed its response to the NPL crisis that emerged from about 1994. In the beginning the authorities believed that government support to recapitalisation and consolidation in the banking sector would be sufficient to encourage a cleansing of distressed loans. It was only with the establishment of an independent regulator that a full assessment of banks' capital positions became possible. NPLs then declined dramatically from about 2001 as two centralised AMCs acquired and disposed of them.[8]
- In the **euro area** NPLs are increasingly recognised as a key factor in holding back a recovery in investment and growth, though also as a reflection of banks' poor earnings and capital coverage. Ireland and Spain benefitted from fairly comprehensive banking sector restructuring and recapitalisation under EU/IMF programmes, and asset management companies in these countries focused on well-defined problem assets in commercial and residential real estate. By contrast, the assets in other euro area countries with elevated NPL ratios, such as Greece, Slovenia or Portugal and Italy, are concentrated in more complicated corporate and SME loan portfolios.[9]
- The countries of **central Europe and southeastern Europe (CESEE)** experienced a severe NPL crisis as rapid inflows of bank credit and excessive lending came to an abrupt end. Latvia, for instance, saw the largest GDP contraction of any emerging market in the wake of the global crisis, with NPLs peaking at over 20 per cent. In working out its NPL problem, Latvia conducted legal reforms that prioritized restructuring over liquidation. Elsewhere in the region, the rapid NPL reduction in Romania has been impressive, and Slovenia and Hungary established centralized asset management companies. Overall the region benefits from the extensive networks of European banks which are under pressure to reduce NPL levels.[10]
- **China** is another case study[11] as it confronts an increasingly urgent problem of excessive corporate debt (estimated at over 170 per cent of GDP, much of it is among state-owned enterprises) against the backdrop of an economy that is slowing and re-balancing away from sectors with excess capacity. Corporate debt has risen rapidly over the last few years, and is now at a level usually associated with

[7] Demertzis and Lehmann (2017)

[8] Gandrud and Hallerberg (2017)

[9] Demertzis and Lehmann (2017)

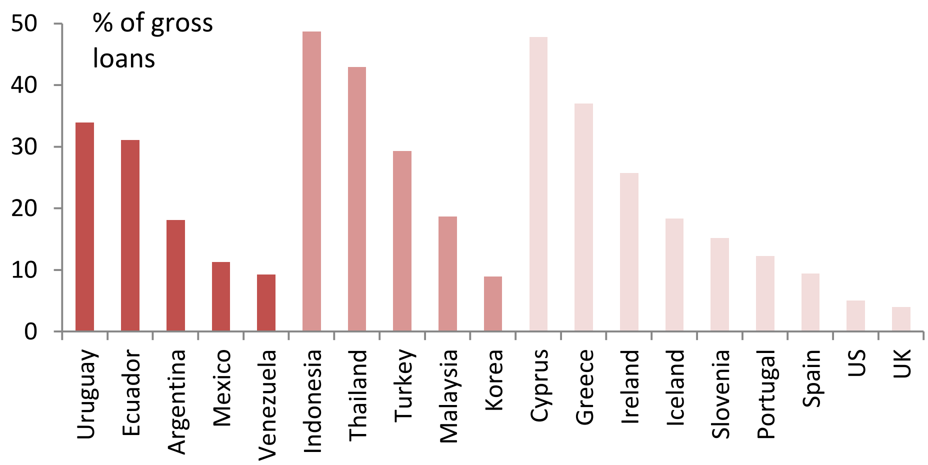
[10] An overview of regulatory barriers is in EBCI (2012), and current reforms are summarised at http://npl.vienna-initiative.com/

[11] While certain features of the Chinese economy are similar to Belarus (e.g. the SOE/state bank nexus), one should not stretch the comparison too far, especially in terms of available policy buffers (e.g. high FX reserves, low level of public debt, level of provisioning and capitalisation of the banking system) for the authorities in China.

advanced economies with much more sophisticated financial markets. In early 2016 the authorities announced a strategy based on conversion of distressed debt into equity, and securitization of such loans. Some observers have pointed out the lack of a strategy for assessing the viability of firms, and for broader debt and operational restructuring that limits the state's role, and establishes hard budget constraints. Generally, banks are note well-equipped to manage equity in firms.[12]

Figure 3

Peak of NPLs in selected countries



Source: World Bank

5. Best practices in supervision and banks' handling of NPLs

NPLs should not be seen as a problem whose origin is external to the banking sector. NPLs are a reflection of corporate and household debt distress and at the same time a symptom of banking sector undercapitalization. Adequate capital coverage is therefore a prerequisite for allowing banks to fully engage in NPL resolution and financial restructuring of borrowers. It will signal to the private sector that the banking sector is prepared to withstand the value correction that occurs in the process of debt restructuring.

But as the experience from other markets in the previous section make clear, strict regulation and supervision tailored to a systemic problem with loan defaults is important. There has been considerable progress in this area in Europe, from which countries such as Belarus could benefit. These are the key areas where there could be convergence with EU practice:

- Adoption of a uniform asset classification methodology, ideally that proposed by the European Banking Authority (EBA) in 2015, or that proposed recently by the Basel Committee.
- Early and adequate provisioning against loans that are at risk, even they may not yet be in default. New EU accounting standards (IFRS 9) will from next year require forward-looking credit risk models that could lead to impairments of EU banks rising ahead of loan delinquency.

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[12] Daniel et al (2016) and Maliszewski et al (2016)

- Lifting of restrictions on the transfer of assets either between creditors, or from individual banks to investors who seek to acquire title and manage these assets. Banks may need to own and operate the assets that they acquire in the process of restructuring.
- Uniform standards in appraisals that provide consistent valuation of collateral.

But supervision should go beyond enforcing prudential standards and needs to address capacity gaps within the banks.

All banks typically have a workout department to which all loans are moved at a certain stage of distress. Such units will have specialist staff experienced in restructuring and with access to the required internal legal support. But workout departments are typically under-resourced, and not sufficiently incentivized. Engagement with investors and with other banks is made more difficult due to poor documentation of the loans that are managed and lack of authorization to participate actively in restructuring.

For this reason, the European Central Bank, as the supervisor of the largest banks in the euro area, recently adopted guidelines on best practices in this area (ECB, 2017). These guidelines set standards in terms of management capacity, loan documentation and engagement with investors. It tasks banks' workout units with the early restructuring of distressed assets, and resolution or foreclosure in coordination with other lenders once the borrower has been deemed non-viable. Similarly intrusive supervision was implemented in a number of emerging markets, such as Korea.

6. Asset separation within distressed banks and in systemic NPL crises

Beyond a certain point the workout department of an individual bank will be overwhelmed by the scale of the problem. Handling of the distressed loan portfolio absorbs the bank's management to such an extent that normal new business can no longer be conducted. More fundamentally, banks generally set poor incentives for their staff. Debt restructuring involves difficult decisions in writing down claims, and the equity value of owners and long-standing clients of the bank. Bank staff who has been involved in the origination of the distressed loan will rarely be empowered to restructure loans in a way that maximizes value recovery. Moreover, restructuring requires specialist skills which are normally in short supply in the bank, if not in the industry as a whole.

Internal asset separation

A key element in any NPL resolution strategy is therefore the separation of distressed assets from the healthy part of a bank's balance sheet. The objective is to eliminate the risk to the valuation of the bank that is due to the uncertain asset quality and recovery values, and thereby return the remainder of the bank to viability. This restores the confidence of depositors and investors. New business once again becomes possible. Asset separation is imperative once the bank is in distress, and deposits are rapidly flowing out as capital coverage diminishes. Two options exist for an asset separation that is limited to operational aspects, though these may not be effective in Belarus[13]:

- A 'non-core' division, or internal 'bad bank'. Such a unit would be exclusively tasked with the run-off of distressed assets and be subject to clear performance targets in terms of asset reductions by the main

[13] See Lehmann (2017)

bank. Ultimately, the consolidated balance sheet will of course remain at risk, and such a unit has little value where corporate governance is weak.

- In an asset protection scheme certain assets are 'ring-fenced' within the bank's balance sheet and guaranteed by the government. This measure has been employed in a number of European crisis situations, for instance in the UK, and can secure the bank against further value loss. It is of course not an option where the bank is already state-owned, or where the government balance sheet is already at risk from ownership stakes in the banking sector.

Sale of assets to independent investors or to asset management companies

In the end only a complete separation of the affected assets into a legally distinct balance sheet will meet the dual objectives of restoring confidence and preventing the further drain that questionable assets exert on capital and profitability of the bank's core assets. The outright sale of NPLs to independent investors is generally difficult in emerging markets, as such sales always confront the problem of information sharing. Where the selling bank can select the assets it offers for sale, the investor will offer a price that is based on the assumed composition of loan quality. On that basis, the selling bank will select poorer quality assets that match this lower price. The market will not clear, which is a typical example for adverse selection. This problem is particularly daunting where the legal regime is not transparent or enforcement is difficult. In addition, the bank that will enter this illiquid market for the first time will likely be offered a particularly steep discount, and the need for additional provisions will be particularly large.

Given the problems inherent in the direct sale of distressed loans a government may set up an asset management company. The AMC could be an instrument in the resolution of an individual bank that is in distress (a process known as a 'bank de-merger'). In such cases, the troubled bank is split into a good bank (or a bridge bank) and a bad bank. The latter would not have a license for new bank business but only for maximising value in recovery and would subsequently be sold or liquidated, with the deadline set by law. Government ownership is generally inevitable. There have been numerous such bad-bank splits in the aftermath of the recent European crisis. A case geographically close to Belarus is that of Parex bank in Latvia.[14]

Where distress from debt and NPLs is systemic the government will consider a centralized AMC that will work with all distressed banks, as was done for instance in Spain (Sareb) or Ireland (Nama). A centralized AMC has several advantages:

- It will establish uniform and credible valuation criteria for distressed assets and collateral. This will give banks a predictable and uniform baseline against which they can judge restructuring options.
- A sector-wide bad bank will also give momentum to corporate debt restructuring. Where such an AMC is created as part of wider sector restructuring, and where it is publicly owned, it will be in a position to impose conditions on bank restructuring for those banks that transfer assets. The AMC should have a clear mandate to restructure and maximize value that is recovered within a certain timeframe. As we

[14] Parex was Latvia's second largest bank, and the only systemic bank that was domestically owned. Following a bank run and a 36 percent fall in deposits, the bank was nationalised in 2008 and then split into two. The bad bank retained the remaining non-core and non-performing assets and began work with the aim of maximising the repayment of state aid by end-2017. Until end-2016, this bank ('Reverta') recovered 65 percent of its assets. The healthy bank ('Citadele') was privatised in 2015 and has since returned to profitability.

will show in the next section, this is normally achieved through restructuring a business as a going concern. Where loans to a single enterprise are held by a number of creditors, the AMC could facilitate coordination.

- Finally, the AMC will build a skills base that is not available in the banks. It may do so by hiring specialist experts, by subcontracting the management of its portfolio to servicing companies, or by engaging investors who acquire assets and manage a restructuring process.

The pre-requisite for successful bank restructuring and asset separation is that a realistic valuation is established for the assets that are transferred. This may not be entirely accurate at first, though speed is of the essence as value is being lost in over-indebted borrowers. Errors in the initial valuation will result either in a write down or in a capital gain in the state-owned AMC, and the corresponding impact on the capital position of the banks. If this is a transfer from state banks to a state-owned AMC, the accounts are in any case the same.

While there are many benefits in using a central asset management company, the bad bank is no panacea. The transfer will often require additional provisioning, and a capital injection in the banks[15]. The AMC can become an effective instrument in debt restructuring, though this will depend on political willingness to allow the resulting corrections in banks' claims and equity ownership in the borrowers. Operational restructuring, such as the closing of certain business lines, will normally follow.

7. Tackling excess debt through well designed frameworks for restructuring and insolvency

The initial impetus for NPL resolution must come from the supervisor who will seek to keep in check deterioration in banks' asset quality, capital position and earnings. However, this effort needs to be matched by a strengthening of the legal regime for financial restructuring and insolvency. Whichever way the bank chooses to reduce delinquent debt, ultimately the unsustainable debt of the borrower will need to be addressed.

The key role of an effective insolvency regime is to allocate risk between borrowers and lenders in a predictable and transparent way so that new lending takes place and borrowers remain subject to credit discipline. Also, the regime should help to identify businesses that are not viable, and facilitate their speedy liquidation.[16] Businesses that suffer from excess debt but which are in principle viable should be given options to restructure their debt. For lenders the restructuring and continuation of such businesses "as a going concern" is almost always superior to their liquidation.[17]

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[15] In Belarus, the recent transfer of NPLs to the AMC was apparently done at face value, which allowed banks to write back previously booked loan-loss provisions.

[16] A borrower's credit quality is typically assessed on the basis of indicators of liquidity and solvency. Viability is a broader concept that describes the borrower's capacity to meet scheduled and future credit obligations from the flow of future earnings while delivering on the existing business plan. Investors and restructuring firm would conduct an assessment of viability to determine the need for partial liquidation.

[17] See the World Bank's Principles for Effective insolvency and creditor/debtor regimes

A recent survey nevertheless found that corporate insolvency procedures in the emerging Europe region are largely biased towards liquidation rather than restructuring.[18] Costs and efficiency of insolvency procedures still vary greatly (Figure 4). There are rarely procedures in place that encourage the early rescue of firms. Recognizing that it is costly to prolong unsustainable debt among enterprises, and to liquidate enterprises that could have been salvaged at an earlier stage, a number of countries have now reformed their legal regimes in line with international best practice. Lithuania and Slovenia have been reasonably successful in this area.

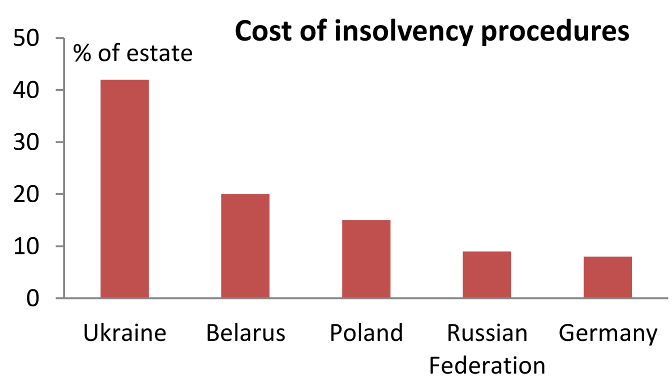
But procedures that are supervised and sanctioned by a court can be lengthy and costly. It is often sensible to complement judicial procedures with less formal out-of-court procedures to facilitate debt settlement and restructuring. The so-called INSOL principles that have been adapted to the legal context in several CESEE countries have facilitated early debt resolution.[19] The crucial role of such private agreements is to overcome the collective action problem between multiple lenders that seek to design and enforce a restructuring plan. Such a plan may be sensible collectively, though will require each creditor to give up certain rights. Out-of-court procedures can be either entirely voluntary or be supervised by the government or central bank. They are essential in avoiding an over-reliance on the courts.

Crucially, the legal regime needs to be matched by adequate capacity in the judiciary. Courts should be resourced to hear cases quickly, ideally in courts that are specialized in insolvency. Also, the judiciary needs to be supported by a sufficiently deep professional body, for instance accountants, or audit professionals.

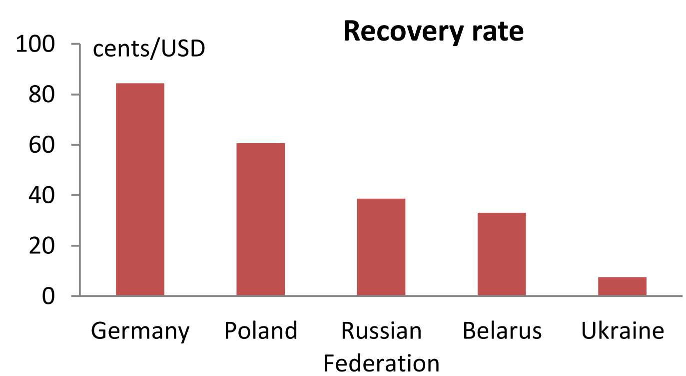
Many restructuring options may give rise to additional taxation for an enterprise that is already in financial distress. Also, the public sector (for instance the social security accounts) may be called upon to participate in the write offs. If the public sector supports such restructuring this may have a short term revenue impact, though the renewed growth of an enterprise that has returned to health is likely to compensate for this.

Figure 4

Cost and efficiency of insolvency procedures in selected transition countries



Source: World Bank



Source: World Bank

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[18] EBCI (2012)

[19] The principles can be downloaded from www.insol.org

8. Conclusions: Lessons for Belarus

Since early 2016 Belarus, has seen a sharp increase in NPLs. This is an experience shared with many other transition countries. Since the debt crises in emerging markets in the late 1990s, and more recently the global financial crisis and the debt crisis in the EU, a clearer picture has developed as to how bank supervision and legal reforms can respond to the profound challenges NPLs pose to financial stability and growth.

Typically, successful policy response prioritized a consolidation and recapitalization of banks. Only then can banks actively participate in restructuring or foreclose on borrowers where these are clearly not viable and this is inevitable. Successful instances of NPL resolution then exhibited a number of common policy elements:

Supervision encouraged early write-down and foreclosures. In Korea and Japan, for instance, supervisors stipulated criteria through which banks would identify those firms where restructuring could be promising. Banks in Ireland were required to report in great detail on their NPL portfolios and were also given guidelines for the engagement with delinquent borrowers, and for the reduction of distressed portfolios.

In parallel countries reformed their legal frameworks for insolvency and restructuring. This is important so that banks and borrowers have a clear sense of the expected timeline and potential pay-offs in restructuring and potential liquidation. Also, where restructuring leads to an injection of fresh capital, and improved management, this may underpin a broader recovery in the corporate sector. It is crucial that this legal reform is accompanied by improved capacity in the courts, and among insolvency professionals.

Crisis countries also facilitated out-of-court restructuring of over-indebted companies, including by defining guidelines for the coordination between multiple creditors.

Belarus is still an economy with wide-ranging state ownership in the financial as well as the real sector, and significant amounts of directed and subsidized lending. Resolving NPLs is therefore part of a broader structural reform agenda to overcome the problem of soft budget constraints of state-owned enterprises (SOEs). Financial restructuring of delinquent borrowers will need to be done in conjunction with reducing the subsidies that are implicit in soft taxation, in soft loans and in the accumulation of arrears between firms and in payments to workers. Financial discipline needs to be bolstered through an effective insolvency law, and creditors' capacity to enforce on collateral, even if the client happens to be in state ownership. Ultimately, this will require a gradual shift in the overall economic policy model of the country towards greater market orientation and higher efficiency.

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